

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

November 13, 2002

IN RE:

**PETITION OF CHATTANOOGA GAS
COMPANY FOR APPROVAL OF
CHANGE IN PURCHASE GAS ADJUSTMENT**

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**DOCKET NO.
02-00383**

**ORDER DENYING PETITION FOR APPEAL AND
AFFIRMING THE INITIAL ORDER OF THE HEARING OFFICER**

This matter came before Chairman Sara Kyle, Director Deborah Taylor Tate and Director Ron Jones of the Tennessee Regulatory Authority (the "Authority"), the voting panel assigned in this docket, at the regularly scheduled Authority Conference held on September 23, 2002 for consideration of the *Petition for Appeal* ("Petition"), filed by Chattanooga Gas Company ("Chattanooga Gas") on September 6, 2002. In its Petition, Chattanooga Gas requests that the Authority reverse the August 30, 2002 *Initial Order of Hearing Officer on the Merits* ("Initial Order," attached as Exhibit A) and approve the experimental Fixed Rate Tariff.

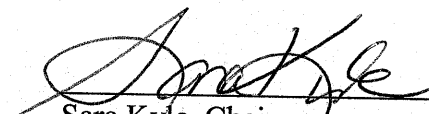
On September 13, 2002, the Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate") filed the *Attorney General's Opposition to Chattanooga Gas Company's Appeal of Order Denying Its Experimental Tariff* ("Opposition of Consumer Advocate").

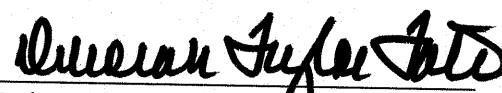
After reviewing the Initial Order, the Petition, and the Opposition of the Consumer Advocate as well as the record in this matter, at the September 23, 2002 Authority Conference

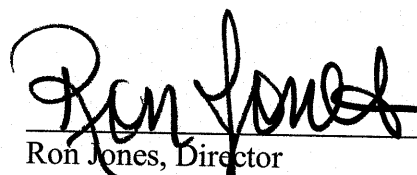
the Directors voted unanimously to deny the Petition and to affirm the Hearing Officer's Initial Order.

IT IS THEREFORE ORDERED THAT:

1. Chattanooga Gas Company's Petition for Appeal is denied;
2. The August 30, 2002 *Initial Order of Hearing Officer on the Merits*, attached to this Order as Exhibit A, is hereby affirmed and adopted as if fully rewritten herein;
3. The experimental Fixed Rate Tariff is denied; and
4. Any party aggrieved by the decision of the Authority may file a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from the date of this Order.


Sara Kyle, Chairman


Deborah Taylor Tate, Director


Ron Jones, Director

BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:

**PETITION OF CHATTANOOGA GAS
COMPANY FOR APPROVAL OF
CHANGE IN PURCHASE GAS ADJUSTMENT**

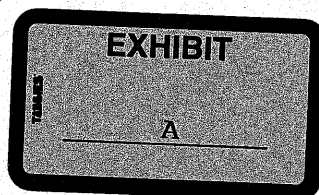
**DOCKET NO.
02-00383**

INITIAL ORDER OF HEARING OFFICER ON THE MERITS

This matter is before the Tennessee Regulatory Authority (the "Authority" or "TRA") for consideration of Chattanooga Gas Company's ("Chattanooga Gas," "CGC," or the "Company") *Petition for Approval of Change in Purchased Gas Adjustment* (the "*Petition*"). On May 28, 2002, a Hearing was held before Hearing Officer J. Richard Collier, for the purpose of allowing Chattanooga Gas to introduce evidence in support of its *Petition*. The Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate") participated in the Hearing and presented testimony.

BACKGROUND

Chattanooga Gas filed its *Petition* with the Authority on April 8, 2002, seeking approval of a tariff that would change the Company's existing Purchase Gas Adjustment ("PGA") rider by establishing an Experimental Fixed Rate Tariff ("FRT"). In the *Petition*, Chattanooga Gas states that the "purpose of the FRT is to provide customers of Chattanooga Gas with certainty on an



annual basis relative to their natural gas rates, regardless of consumption or weather.”¹ The *Petition* further states:

Chattanooga Gas developed the FRT in response to the financial hardships faced by residential and small commercial customers due to the volatility in natural gas wholesale prices during the past winter heating seasons, particularly the winter of 2000, and in response to the request of the TRA that gas companies be actively engaged in developing methods to reduce the impact of gas price volatility on natural gas customers.²

According to the *Petition*, the experimental FRT would, if approved, be in effect for a three (3) year period beginning October 1, 2002 and would apply to Chattanooga Gas’s Residential General Service (R-1), Multi-Family Housing Service (R-4), and Commercial and Industrial General Service (C-1) rate schedules, and it would supersede Chattanooga Gas’s regular PGA rider for these rate schedules. The *Petition* states that in order to establish a fixed rate for customers, Chattanooga Gas will enter into a fixed rate gas supply contract by October 1 of each year. Further, Chattanooga Gas “will assume certain risks as a result of entering into a long term contract.”³ Because of these risks, the FRT includes a “risk premium.”

The FRT proposed in Chattanooga Gas’s *Petition* is similar in purpose and general approach to the FRT proposed by Chattanooga Gas in its *Petition for Approval of a Tariff Establishing an Experimental Fixed Rate PGA Rider* (“*First Petition*”) filed in Docket No. 01-00761 on August 31, 2001. In its *First Petition*, Chattanooga Gas requested Authority approval of a tariff establishing an experimental three (3) year period during which, rather than passing through its actual costs of supplying gas to its customers, Chattanooga Gas proposed to freeze its customers’ rates for three (3) successive twelve (12) month periods. As stated in the *First*

¹ *Petition for Approval of Change in Purchased Gas Adjustment* (“*Petition*”), Docket No. 02-00383, April 8, 2002, p. 3.

² *Id.*

³ *Id.*, p. 4.

Petition, the proposed tariff involved a waiver of the Authority PGA Rules.⁴ Chattanooga explained that the proposed FRT was a response to “the financial hardships faced by residential and small commercial customers due to the volatility in natural gas wholesale prices during the past winter heating season.”⁵ Chattanooga Gas explained that it would “assume certain risks as a result of entering into a long term contract.”⁶ Chattanooga Gas further stated that “to compensate for such risks, the FRT includes a ‘risk premium’.”⁷

Petitions for intervention were filed in Docket No. 01-00761 by the Consumer Advocate and by Dynegy, Inc., (“Dynegy”). On September 25, 2001, the Authority convened a contested case proceeding, granted the petitions for intervention, and appointed a Pre-Hearing Officer to establish a Pre-Hearing schedule. On September 27, 2001, Chattanooga Gas filed a *Withdrawal of Petition* (“*Withdrawal*”). In its *Withdrawal*, Chattanooga Gas reiterated that the *First Petition* was “filed in response to concerns raised by Chattanooga Gas customers and the TRA regarding the volatility in gas costs experienced during the winter of 2000/2001.”⁸ According to Chattanooga Gas, the *First Petition* “was an attempt by Chattanooga Gas to develop a creative win/win response that would guarantee a flat rate for residential and commercial customers.”⁹ Chattanooga Gas expressed concerns about “the motives of Dynegy, Inc. in participating in this docket,”¹⁰ and stated that by convening a contested case and granting Dynegy, Inc.’s intervention it would not be possible for the Authority to render a decision within the time frame requested by Chattanooga Gas. On October 9, 2001, during a regularly scheduled Authority Conference, the

⁴ Tennessee Regulatory Authority Rules Chapter 1220-4-7.

⁵ *Petition for Approval of a Tariff Establishing an Experimental Fixed Rate PGA Rider (“First Petition”)*, August 31, 2001, p. 3.

⁶ *Id.*, p. 4.

⁷ *Id.*, p. 5.

⁸ *Withdrawal of Petition (“Withdrawal”)*, TRA Docket No. 01-00761, September 27, 2001. p. 1.

⁹ *Id.*, pp. 1-2.

¹⁰ *Id.*, p. 2.

Directors unanimously accepted the *Withdrawal* of Chattanooga Gas. In addition, the Directors stated that the responsibility of the Company to take all reasonable and prudent measures to purchase gas at the lowest possible price was not lessened by its withdrawal of the *First Petition*. In addition, Chattanooga Gas was reminded that such measures were already possible within the framework of the Authority's PGA Rule.

Travel of This Case

Following the filing of the *Petition*, the Authority issued a data request to Chattanooga Gas. In its April 23, 2001 response to that data request, Chattanooga Gas states that the major additions that distinguish the proposal in the current *Petition* from that filed in the *First Petition* include specific identification of three (3) additional risk factors in the proposed formula and a reduction in the risk premium for unspecified risks. These three (3) risk factors encompass volume and capacity cost variables caused primarily by weather and by lost and unaccounted-for gas.¹¹ The current *Petition* still hedges on one hundred percent (100%) of price variations for one (1) year intervals in exchange for a non-optional rate increase.

According to the *Petition*, a new fixed rate will be computed by October 1st of each year during the three (3) year period. By September 1st of each year, "a pro forma of the fixed rate shall be filed with the Authority indicating the market conditions for wholesale gas prices at that time."¹² The *Petition* states:

Although the pro forma will not set forth a guaranteed fixed rate, the Authority will have good indications of the market conditions and the estimated rate thirty days before implementation of the new annual fixed rate and can use this information as a basis to determine whether it will approve the tariff for the ensuing year.¹³

¹¹ Response to Tennessee Regulatory Authority Staff Data Request No. 1, Docket No. 02-00383, April 23, 2001, Item 1.

¹² *Petition* at p. 4.

¹³ *Id.*, pp. 4-5.

With the *Petition*, Chattanooga Gas filed a formula for computation of the fixed rate, witness testimony describing the FRT, and a “pro forma reflecting current market conditions.”¹⁴ Chattanooga Gas requests “approval of the tariff, which constitutes a formula and a concept.”¹⁵ Chattanooga Gas further states that if the *Petition* is approved, the Company “would file a new pro forma on September 1, 2002 reflecting the then current market conditions which would serve as the basis for the Authority to decide whether it should allow the FRT to go into effect for the ensuing year.”¹⁶ Proposed tariff sheets filed with the *Petition* state that the Authority would have until September 25th of each year to decide whether to “halt this Fixed Rate PGA Rider,” and suspend the tariff for the next twelve (12) months, or approve the proposed fixed rate and allow the tariff to go into effect for the next twelve (12) months.¹⁷

In conjunction with the FRT, Chattanooga Gas requests that the Authority waive the requirements of the PGA Rule (TRA Rule 1220-4-7) for the affected rate schedules “because the fixed rate obviates the need for computing the adjusted rate as set forth in the rule.”¹⁸ Such a waiver, the *Petition* states, would also include a waiver of the prudence audit provided for in the PGA Rule.

With its *Petition*, Chattanooga Gas submitted the pre-filed testimony of Mr. Larry Buie, General Manager of Chattanooga Gas; Mr. William H. (“Hal”) Novak, Vice President of Regulatory Compliance for Sequent Energy Management, LP (“Sequent”)¹⁹; and Ms. Beverly Wright, the research consultant who conducted focus group sessions at the request of

¹⁴ *Id.*, p. 5.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Petition*, Exhibit A, Original Sheet No. 40.

¹⁸ *Petition* at p. 5.

¹⁹ Sequent Energy Management, LP is a wholesale gas trading and optimization company with offices in Atlanta, Georgia and Houston, Texas. Sequent is a subsidiary of AGL Resources and an affiliate of Chattanooga Gas Company. (See *Petition*, Exhibit C, Testimony of William H. Novak, p. 1.)

Chattanooga Gas. With its *Petition*, Chattanooga Gas also submitted three (3) videotapes, of approximately two (2) hours each, showing three (3) focus group sessions conducted by Ms. Wright. These sessions included written and oral surveys of the participants reflecting their opinions regarding the proposed FRT.²⁰

At the May 7, 2002 Authority Conference, the Directors of the Authority voted unanimously to convene a contested case proceeding in this matter and to appoint the General Counsel or his designee as Hearing Officer to make findings of fact and conclusions of law and to render an initial decision on the merits of Chattanooga Gas's *Petition*.²¹ A Pre-Hearing Conference was held on May 7, 2002 during which the parties agreed to a procedural schedule governing the filing of discovery and pre-filed testimony. The Hearing in this matter was set for May 28, 2002. An Order reflecting the schedule and Hearing date was issued on May 9, 2002.

The Consumer Advocate participated in the Pre-Hearing Conference, without objection, in advance of requesting formal intervention. On May 9, 2002, the Consumer Advocate filed a *Petition to Intervene* in this matter. The Consumer Advocate stated as grounds for its *Petition to Intervene* that the "risk premium is too high and is not reasonable for consumers in Chattanooga."²² Further, the Consumer Advocate stated that the "tariff has no option for consumers" and "is not the kind of consumer choice Tennesseans should expect."²³ By Order dated May 23, 2002, the Hearing Officer granted the Consumer Advocate's *Petition to Intervene*.

²⁰ Chattanooga Gas filed a Market Research Report dated February 21, 2002, which explains the focus groups. According to this Report, the focus groups consisted of thirty-one (31) randomly chosen commercial and residential customers of Chattanooga Gas, who were instructed and surveyed regarding the proposed FRT in three (3) sessions on January 25, 2002. See BMR and Associates, Market Research Report, February 21, 2002, attached to Response to Consumer Advocate and Protection Division May 13, 2002 Data Request, Docket No. 02-00383, May 17, 2002.

²¹ An Order reflecting this action was issued on May 13, 2002.

²² *Petition to Intervene*, Docket No. 02-00383, May 9, 2002, p. 2.

²³ *Id.*

Pre-Filed Testimony Submitted by Chattanooga Gas

In his pre-filed testimony submitted with the *Petition*, Larry Buie describes the proposed FRT as follows:

The Company's Fixed Rate PGA Tariff "locks in" the price of gas for the Residential and Small Commercial customers for a one-year period regardless of consumption or weather. In contrast, the Company's regular PGA changes the gas rate for these same customers on a monthly basis, and is dependent on the wholesale gas price that is available on the spot market. While the Company's proposed Fixed Rate PGA does not guarantee a lower total cost to the customer over a twelve month period, it does eliminate the price volatility that has been the source of many complaints to the Company and the Tennessee Regulatory Authority.²⁴

Mr. Buie states that the volatility in wholesale gas rates is demonstrated by the fact that "[s]ince the Company's last rate case in 1998, the monthly gas rate has ranged from a low of \$0.319 per hundred cubic feet to \$1.008 per hundred cubic feet last winter."²⁵ According to Mr. Buie, "wholesale price volatility has been a source of contention with many of our Residential and Small Commercial customers who depend on a stable gas rate to help them budget their energy expenditures."²⁶ He adds that the FRT "eliminates this volatility by offering a fixed, stable rate for wholesale gas that will not change over the next 12 months."²⁷

Mr. Buie states that the fixed price could be obtained because Chattanooga Gas "has several hedging tools available to it where it can 'lock in' or hedge a unit price today for wholesale gas to be delivered over the next twelve months."²⁸ However, Mr. Buie states, "[w]hen the Company hedges prices for wholesale gas purchases over a twelve-month period, it must also decide what corresponding volume of gas to hedge."²⁹ Mr. Buie explains:

²⁴ *Petition*, Exhibit B, Testimony of Larry Buie, p. 2.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*, p. 3.

²⁹ *Id.*

If the Company hedges too much gas (for example, if weather turns out to be warmer than expected) then it will have to find a market for this gas at a price that could be either lower or higher than the hedged price. Likewise, if the Company does not hedge enough gas (for example, if weather turns out to be colder than expected), it will be forced to go back into the market and purchase additional supplies of gas at a price that may be either higher or lower than the hedged price in order to satisfy the demand for gas from our customers. . . . Because the Company is assuming this risk regarding the correct volume of gas to hedge, we have included a Risk Premium variable in Fixed Rate PGA Tariff formula.³⁰

Mr. Buie testified that Chattanooga Gas considered offering the FRT as an optional service but determined that the cost of changing its computer system to accommodate an optional program would be prohibitive.³¹ Mr. Buie further asserts that an optional program “would require an extensive customer education campaign as well as additional training and staffing in our call center.”³²

In his pre-filed testimony, Sequent Vice President Hal Novak described how the FRT works:

The Fixed Rate PGA is designed to work in somewhat similar fashion to the Authority’s existing PGA rule with the forecasted costs and volumes producing a gas rate to be charged to CGC’s customers. However, unlike the Company’s existing PGA Rider, the proposed Fixed Rate PGA Rider contains a risk premium (RP) to compensate for the risks assumed by the Company that could not be separately identified in making this tariff available.³³

Mr. Novak explained the proposed FRT formula:

The first part of the formula aggregates the projected monthly commodity, storage demand and lost and unaccounted-for gas costs in the numerator, and then divides this projected annual cost by the annual projected sales volumes in the denominator. This produces the weighted average expected rate that the Company anticipates it will be able to deliver to its customers. The second part of the formula adds in the projected interstate pipeline transportation rate. Finally, the third part of the formula adds in a Risk Premium.³⁴

³⁰ *Id.*, p. 4.

³¹ *Id.*, p. 5.

³² *Id.*

³³ *Petition*, Exhibit C, Testimony of William H. Novak, p. 2.

³⁴ *Id.*, p. 3.

Mr. Novak discusses each component of the formula in his pre-filed testimony. As to the risk premium, he states:

There are several risk burdens that are currently recovered automatically through the PGA process that will now be transferred to the Company's affiliate in order to make the Fixed Rate PGA feasible. Many of these risks are difficult to quantify as a separate component of the Fixed Rate PGA, since their magnitude and probability of occurrence are unknown.³⁵

Mr. Novak lists several potential risks, which include possible conversion by an industrial customer to an interruptible rate schedule as well as possible changes in interstate transportation, storage and capacity rates by the Federal Energy Regulatory Commission. Mr. Novak describes the manner in which Chattanooga Gas arrived at its proposed risk premium:

The Company internally considered the risks described above for this tariff that it feels it will be required to absorb over the plan year. After considering several methods for determining this risk, we are proposing to use the utility's authorized rate of return of 9.08% and applying it to all other costs identified in the Fixed Rate PGA. When this rate is applied to the Fixed Rate PGA, it produces a current Risk Premium of approximately \$0.05 per Ccf as shown on Exhibit WHN-2. This Risk Premium is also substantially less than the \$0.12 per Ccf that the Company proposed in its original filing last year.³⁶

Mr. Novak further explains:

Between September 25th and October 1st, the Company will enter the market and acquire the volumes listed in Exhibit WHN-2, barring any force majeure situation (tornado, hurricane, explosion or other natural or mechanical disaster) occurring in the gulf or other production areas. Once the volumes have been acquired, we will calculate the final fixed price and provide it to the Authority along with the commodity prices that were obtained for October 2002 through September 2003. We will also provide the Authority with a copy of the supplier's confirmation sheet for the wellhead gas purchased. This confirmation will indicate the volumes that were fixed at a specific price per month.³⁷

According to Mr. Novak, on the basis of the information thus supplied, the Authority would be able to determine whether the price for gas paid the Company was between the daily highs and

³⁵ *Id.*, p. 8.

³⁶ *Id.*, p. 9.

³⁷ *Id.*, pp. 10-11.

lows posted in various publications, such as *Gas Daily*.³⁸ Mr. Novak further states, "Fixing the price for natural gas provides the customer with a known price for service over the next 12 month period. It does not guarantee the lowest cost."³⁹

Chattanooga Gas' research consultant, Beverly Wright, testified that she was hired "to perform a series of customer focus groups for the purpose of obtaining attitudes of Residential and Small Commercial customers towards the Company adopting an annual fixed-rate purchase gas adjustment factor."⁴⁰ Ms. Wright explains the use of focus groups as follows:

As published by the American Marketing Association, a focus group is a form of qualitative research and a means of obtaining opinions related to a specific topic. Focus groups should be conducted in a free-flowing, loosely structured manner using a focus group moderator, usually external to the organization sponsoring the focus groups. Groups typically consist of eight to twelve people with some common characteristics. One of the most common reasons for focus group research includes testing new concepts. Focus group research should not be used to determine specific percentages and exact measurements of opinions.⁴¹

Ms. Wright states that the thirty-one (31) participants in the three (3) focus groups she conducted were selected at random from Chattanooga Gas customers.⁴² While the results of the focus groups are not necessarily representative of the Company's customers as a whole,⁴³ Ms. Wright drew the following conclusions from the focus groups:

- 1) Customers from the groups would probably not notice a change of the proposed nature in their natural gas bills.
- 2) The majority of customers from the study (about 2/3) are either indifferent to or in favor of the proposal.
- 3) Providing information addressing customer concerns regarding assignment or risk and potential losses has an important role in the development of customer opinion of the proposal. There was a noticeable shift away from customer opinions against the proposal when this

³⁸ *Id.*, p. 11.

³⁹ *Id.*

⁴⁰ *Petition*, Exhibit D, Testimony of Beverly Wright, p. 2.

⁴¹ *Id.*

⁴² *Id.*, pp. 4-5.

⁴³ *Id.*, p. 5.

- information was included in the proposal.
- 4) Customers from the study have a sense of very low control over what they are charged and how they are charged for their natural gas.⁴⁴

Pre-Filed Testimony Submitted by the Consumer Advocate

On May 21, 2002, the Consumer Advocate filed the Direct Testimony of Robert T. Buckner, Coordinator of Regulatory Analysts, and Michael D. Chrysler, Regulatory Analyst, both with the Consumer Advocate's office. Both witnesses testified in opposition to the proposed FRT. Mr. Buckner states that because the FRT includes a risk premium and other pro forma risk protection which are added to the commodity cost of gas charged to consumers, and are not optional for consumers, the FRT is not prudent for consumers.⁴⁵ Mr. Buckner objects to the risk premium because it "provides compensation to CGC which is not based on actual costs."⁴⁶ Mr. Buckner notes that Chattanooga Gas has admitted that the identifiable risks have a low probability of materializing, and asserts that "CGC's customers are being asked to pay a risk premium for risks that either are unknown or cannot be quantified or may not materialize at all."⁴⁷ Mr. Buckner states that "the risk premium and the risk protection additives total approximately \$.09 per Ccf, or based on the latest iteration of the proposed FRT, a 16% mark-up over estimated costs."⁴⁸

Mr. Buckner objects to the manner in which purchases related to the FRT will be handled and criticizes Chattanooga Gas's request for approval of the FRT "without being subject to the bidding process at this time."⁴⁹ He states:

. . . the structure of the proposed FRT provides no real incentive for CGC's

⁴⁴ *Id.*, p. 6.

⁴⁵ Direct Testimony of Robert T. Buckner, Docket No. 02-00383, May 21, 2002, p. 3.

⁴⁶ *Id.*, p. 4.

⁴⁷ *Id.*

⁴⁸ *Id.*, p. 7.

⁴⁹ *Id.*, p. 6.

affiliate, Sequent Energy Management, LP (“Sequent”), to obtain the lowest possible gas commodity costs. Sequent is currently the gas provider for CGC’s customers. At this time, CGC will not take bids from other suppliers for the FRT.⁵⁰

Mr. Buckner also notes that Chattanooga Gas requests a waiver of the prudence audit provided for in Authority Rule 1220-4-7-.05, and he expresses concern that there will be no accounting mechanism to show whether or not the FRT has been successful.

Mr. Buckner states that “since any undercollection/overcollection can be recovered in future periods through the Actual Cost Adjustment (“ACA”), then the existing PGA offering of CGC can eliminate price volatility for a twelve month period.”⁵¹ Mr. Buckner asserts that the FRT “should not be mandated by a utility monopoly or a government entity, but accepted by informed consumers of their own volition.”⁵² Mr. Buckner further objects to the proposed FRT on the grounds that from the results of the focus group sessions, it does not appear that Chattanooga Gas customers are in favor of the FRT.

Michael Chrysler’s testimony focuses primarily on his analysis of the focus group videotapes and documents filed in support of the *Petition*. Mr. Chrysler states that the conclusions drawn by the consultant who conducted the focus groups are “of limited value” because the “results and conclusions of the focus group are not representative of the customer base.”⁵³ With his testimony, Mr. Chrysler provided in Exhibit C-1, a list of programs in five (5) other states in which “Fixed price plans” were made available: New Hampshire, Pennsylvania, Maryland, Indiana, and Illinois. Mr. Chrysler states that in all of these instances, the plans “were only applicable at the customers’ option and have been limited in scope by the state regulatory

⁵⁰ *Id.*, p. 5.

⁵¹ *Id.* (Emphasis removed.)

⁵² *Id.*, pp. 8-9.

⁵³ Direct Testimony of Michael D. Chrysler, Docket No. 02-00383, May 21, 2002, p. 3.

commission.”⁵⁴

The May 28, 2002 HEARING

The Hearing on the merits of the *Petition* was held on May 28, 2002, with the following attorneys appearing on behalf of the parties:

Chattanooga Gas Company - **D. Billye Sanders, Esq.**, Waller, Lansden, Dortch & Davis, Nashville City Center, 511 Union Street, Suite 2100, Nashville, TN 37219-8966;

Consumer Advocate and Protection Division of the Office of the Attorney General and Reporter (“Consumer Advocate”) - **Vance Broemel, Esq.**, Office of Attorney General, 425 5th Avenue North, Cordell Hull Building, Nashville, TN 37243-0500

During the Hearing, Mr. Larry Buie, Ms. Beverly Wright, and Mr. William H. Novak testified on behalf of Chattanooga Gas and were available for cross-examination by counsel for the Consumer Advocate and questions from the Authority Staff. Mr. Michael D. Chrysler and Mr. Robert T. Buckner testified on behalf of the Consumer Advocate and were available for cross-examination by counsel for Chattanooga Gas and questions from the Authority Staff.

At the commencement of the Hearing, counsel for Chattanooga Gas offered proof of notice by publication of the filing of the proposed tariff pursuant to TRA Rule 1220-4-1-.05. Copies of notices published in the *Chattanooga Times Free Press* and the *Cleveland Daily Banner*, newspapers in the service area of Chattanooga Gas were entered into the record as Hearing exhibits.

In his testimony during the Hearing, Larry Buie provided an overview of the proposed FRT and an explanation of the anticipated benefits to customers of Chattanooga Gas. Mr. Buie attributed the development of the proposed FRT to statements made by the Authority’s Directors with regard to gas prices and gas bills at the February 6, 2001 Authority Conference. Mr. Buie stated:

⁵⁴ *Id.*

What Chattanooga gleaned from that conference and from other meetings with the TRA was that the Directors wanted the gas companies to be proactive in coming up with creative ways to help customers to pay their bills when gas prices are high and, if possible, do something to neutralize gas price volatility.⁵⁵

Mr. Buie also attributed the proposed FRT to discussions with representatives of the Tennessee Valley Authority and the Electric Power Board of Chattanooga, in which the “predominant question” that emerged related to the fluctuation of energy pricing.⁵⁶

Mr. Buie acknowledged that “[n]o one knows what the future prices will be; we can only speculate.”⁵⁷ He stated that one virtue of the flat rate is that it simplifies customers’ bills.⁵⁸ According to Mr. Buie, Chattanooga Gas customers in February 2001 “saw a gas rate range from approximately 32 cents a CCF to as high as a dollar [and] one cent a CCF.”⁵⁹ Mr. Buie stated that the fixed rate PGA “will not guarantee the lowest or a particularly lower PGA, but it will offer a fixed rate that will take out the volatility of the cost of natural gas on the market, the spot market.”⁶⁰

Mr. Buie testified that the proposed FRT if approved would not be optional for customers.⁶¹ He explained that Chattanooga Gas had also determined that offering the FRT as an optional program would require changes in its billing system that would be cost prohibitive.⁶² Mr. Buie estimated the cost of an optional program at approximately \$230,000, not including the cost of internal training or the educational component for the customer base.⁶³

Mr. Buie acknowledged that the program would not initially be out for competitive bid,

⁵⁵ *Transcript of Proceedings*, Docket No. 02-00383, May 28, 2002, p. 6.

⁵⁶ *Id.*, pp. 32-33.

⁵⁷ *Id.*, p. 6.

⁵⁸ *Id.*, p. 9.

⁵⁹ *Id.*, p. 15. The transcript reads “almost” instead of “and.”

⁶⁰ *Id.*

⁶¹ *Id.*, p. 16.

⁶² *Id.*

⁶³ *Id.*, p. 31.

but stated that CGC is not opposed to taking bids later.⁶⁴ Mr. Buie stated that he was not sure whether any profit derived from the proposed FRT would go to Sequent or Chattanooga Gas, but that any profit or loss would affect the bottom line for Atlanta Gas and Light Resources, the parent company of both Sequent and Chattanooga Gas.⁶⁵

Mr. Buie stated that Chattanooga Gas had received customer complaints, mostly following the winter of 2000-2001, regarding customers' "higher than usual gas bill[s]."⁶⁶ He added, "I think the high gas pricing will, in fact, create a higher bill and volatility."⁶⁷ Mr. Buie testified that under the proposed FRT, the Authority has the option of terminating the program at the beginning of each one-year period, but not during the year after the program is in operation.⁶⁸

Beverly Wright testified that she was asked to obtain the opinions from Chattanooga Gas customers relating to the proposed FRT. In her testimony, Ms. Wright corrected her pre-filed testimony regarding the results of the focus groups, which resulted in the following changes in the breakdown of customer attitudes toward the FRT: 38 percent (38%) in favor, 30 percent (30%) indifferent, and 32 percent (32%) against.⁶⁹ She reiterated that the results were "not necessarily representative" of the opinions of Chattanooga Gas customers as a whole, stating that the focus groups represented "qualitative research" that is "not projectable" onto Chattanooga Gas's customer base.⁷⁰

According to Ms. Wright's study, in order to consider a billing increase significant, the commercial customers would need to see a bill double the amount of the previous bill, whereas

⁶⁴ *Id.*, pp. 19, 29.

⁶⁵ *Id.*

⁶⁶ *Id.*, p. 24.

⁶⁷ *Id.*

⁶⁸ *Id.*, p. 26.

⁶⁹ *Id.*, p. 37.

⁷⁰ *Id.*, p. 44.

residential customers would need to see only an increase of around fifty percent (50%).⁷¹ Ms. Wright also stated that some customers expressed an interest in receiving other information regarding their gas bills, such as their total amount from previous years for the same month.⁷²

Ms. Wright testified that the presentation of the FRT to the last focus group was modified in such a way that the last focus group was specifically informed that Chattanooga Gas's customers would not "have to pay if anything went wrong."⁷³ After the presentation was modified, Ms. Wright stated, only one customer in the final group expressed opposition to the proposal.⁷⁴

Hal Novak testified that the proposed FRT had been designed for Chattanooga Gas, "to try to eliminate volatile swings in wholesale gas prices that we had experienced."⁷⁵ Mr. Novak's testimony at the Hearing focused on the proposed formula for establishing a yearly fixed rate and the individual components of that formula. Mr. Novak relied upon a chart that he said was a "graphical depiction since Chattanooga's last rate case of the billing rates for wholesale gas that Chattanooga charges its customers."⁷⁶ Mr. Novak stated that the chart demonstrated "quite a bit of volatility."⁷⁷ Mr. Novak explained the difference between Chattanooga Gas's current activities and the proposed FRT as follows:

Currently what we do, we purchase gas on the wholesale spot market on a month-to-month basis. Now, when I say "we purchase this," Sequent Energy Management purchases this gas on behalf of Chattanooga Gas.

And what we propose to do is instead change the way we do this and buy gas on the futures market for 12 months at a time.⁷⁸

⁷¹ *Id.*, p. 53.

⁷² *Id.*, p. 54.

⁷³ *Id.*, p. 56.

⁷⁴ *Id.*

⁷⁵ *Id.*, p. 66.

⁷⁶ *Id.*, p. 66. The chart referred to was Exhibit WHN-3 to Mr. Novak's pre-filed testimony.

⁷⁷ *Id.*

⁷⁸ *Id.*, pp. 67-68.

Mr. Novak explained the inclusion of a "financial collar," which he stated represented a change from the previous proposal:

If our customers use more gas, it lets us go back into the market and buy more gas at that same future rate. And, likewise, if they use less gas, it entitles us to sell gas to someone else at that same future rate. So we have, in effect, locked in that price of gas for the customer.⁷⁹

Additional changes from Chattanooga Gas's previous proposal included modification of the risk premium component, which was previously twelve cents (\$00.12) and inclusion of financial collars totaling approximately four cents (\$00.04) per Ccf.⁸⁰ In addition, Mr. Novak stated that Chattanooga Gas has "voluntarily reduced the risk premium that we filed in last year's docket by 3 cents per CCF or 25 percent of what we filed."⁸¹ Mr. Novak pointed out that this amount is below what is being charged by eight (8) different marketers offering fixed rates in Georgia's market, which he admitted is deregulated, unlike Tennessee's market.⁸²

Mr. Novak referred to Exhibit WHN-5, which he described as a four and a half year backward look at gas prices, to demonstrate "the volatility, especially the peak in the volatility of approximately \$1 per CCF . . .".⁸³ Mr. Novak further stated, referring to Rebuttal Exhibit WHN-6:

you can see that the price for this contract started out in, I believe, November of 2001 at \$3.70. It reached a low in February of 2002 of roughly \$2.95, and it closed about the middle of last week just around \$4.20 per decatherm. So we have continued to see this volatility, and we believe that what we've got here for our customers is a great product, especially if we're going to continue to see peak volatile prices that will - - may not take out all of the volatility and it may not be perfect, but we've offered it as an experimental basis to see what we can do.⁸⁴

⁷⁹ *Id.*, pp. 69-70.

⁸⁰ *Id.*, p. 75.

⁸¹ *Id.*, p. 76.

⁸² *Id.*

⁸³ *Id.*, p. 77.

⁸⁴ *Id.*, p. 78.

Mr. Novak testified that the risk premium was derived by taking "the rate of return that's currently authorized for Chattanooga and apply it to all other costs for the fixed rate PGA up to that point."⁸⁵ He also affirmed the procedure for annual approval of the fixed rate by the Authority:

[I]f the TRA is not happy with the rate that the tariff produces and they let us know approximately five days before we have to go lock in these gas prices, then both sides can walk away from this for a year [and] the tariff is suspended.⁸⁶

Mr. Novak acknowledged that under the proposed fixed rate PGA, if gas prices go down customers would not benefit as they would under the current PGA.⁸⁷

In rebutting Michael Chrysler's pre-filed testimony on the issue of offering the FRT as an option to customers, Mr. Novak stated that the gas companies chosen by Mr. Chrysler for comparison are substantially larger than Chattanooga Gas. According to Mr. Novak:

... the cost for Chattanooga Gas to implement an optional fixed rate PGA would just be prohibitive for us to recover the cost of. There's just not enough of a customer base for us to recover the cost to make it feasible.⁸⁸

Under cross-examination Mr. Novak was questioned about the affiliate relationship between Chattanooga Gas and Sequent and acknowledged that Chattanooga Gas must follow certain affiliate rules under the Public Utility Holding Company Act.⁸⁹ He did not know whether the transactions would be recorded on Chattanooga Gas's or Sequent's books, but stated that the TRA would be provided this information.⁹⁰

⁸⁵ *Id.*, p. 83. Mr. Novak's explanation was much the same as in his pre-filed testimony:
[W]e looked internally at the risk that we would have to bear for offering this fixed rate PGA proposal and we felt that it would take 5 cents per CCF to cover the risk. And at the same time we were looking for some way to calculate what this risk premium should be, and it worked out that the company's current overall return produced approximately the same 5 cents per CCF. *Id.*, p. 90.

⁸⁶ *Id.*, pp. 84-85. Transcript reads "had" instead of "and."

⁸⁷ *Id.*, p. 87.

⁸⁸ *Id.*, p. 79.

⁸⁹ *Id.*, p. 88.

⁹⁰ *Id.*

On the issue of competitive bidding for gas purchasing, Mr. Novak testified that opening the program up to bidding from companies other than Sequent would not benefit Chattanooga Gas's customers. According to Mr. Novak, the cost of Sequent's employees who purchase gas is already a part of Chattanooga Gas customers' base rates. Therefore, buying from another gas purchaser or supplier would involve additional costs to Chattanooga Gas customers.⁹¹ Mr. Novak further stated that there is little to bid on, because Sequent does not mark up the price of gas it purchases for Chattanooga Gas.⁹² He affirmed that Chattanooga Gas does not foreclose bidding in the future.⁹³

Mr. Novak testified that a prudence review would still be conducted, and he added:

The only part that changes about the fixed rate PGA is it's recognized that the prudence test is determined at the time the gas is purchased rather than at the time the gas is delivered because the time the gas is delivered can be as much as 12 months later.⁹⁴

Mr. Novak stated that the proposed FRT allows Chattanooga Gas to be prepared for a price spike in the future.⁹⁵ According to Mr. Novak, the program's value to the Company is that "the next time we get into this peak rate, we've planned for our customers, we've protected them."⁹⁶ He stated that the program may also help with bad debt expense because gas costs locked in at lower rates may result in reducing the amount of customer late payments.⁹⁷

Mr. Novak testified that over the years, Chattanooga Gas has hedged on natural gas by storing a significant amount for winter demand, and this will continue under the proposed FRT.⁹⁸ According to Mr. Novak, the risk premium would likely not appear on customers' bills, but may

⁹¹ *Id.*, p. 92.

⁹² *Id.*, pp. 92-93.

⁹³ *Id.*, p. 93.

⁹⁴ *Id.*, p. 95.

⁹⁵ *Id.*, p. 99.

⁹⁶ *Id.*, p. 116.

⁹⁷ *Id.*, p. 117.

⁹⁸ *Id.*, p. 104.

be explained to customers through bill inserts or newspaper articles.⁹⁹

Mr. Novak explained the procedure for periodic review during the course of the program:

At the end of each year - - well, it's not so much that any particular thing happens at the end of each year, but at the end of each month we will come to the TRA staff, we'll make a presentation of here is the rate we locked in for this particular month, here is what a pro forma PGA under the existing PGA rule we operate under today we feel would have produced, here is how everything is going forward. Here is the rate if we had bought gas on the wholesale market, here is what it's doing and here it is compared with this fixed rate we locked into.¹⁰⁰

Mr. Novak acknowledged that any succeeding year's fixed rate "could be substantially higher or lower" than the previous year's rate.¹⁰¹ Mr. Novak also stated that there are other ways to reduce volatility and the Company would continue to do those with this program in effect.¹⁰²

The Consumer Advocate offered the testimony of Michael D. Chrysler and Robert T. Buckner during the Hearing. The thrust of Mr. Chrysler's testimony was two-fold. He challenged the Company's reliance on the focus group studies and provided information regarding other utilities offering similar fixed rate programs. Mr. Chrysler reviewed the results of the focus groups and concluded that no more than eleven (11) of the thirty (30) participants would choose the proposed FRT.¹⁰³ Mr. Chrysler stated that information he gathered from contacts in the National Association of State Utility Consumer Advocates formed the basis for Exhibit C-1 to his pre-filed testimony, which lists six (6) utilities offering fixed rates on an optional basis.¹⁰⁴ Mr. Chrysler admitted on cross-examination that he did not know how many other companies in the United States offer fixed rate tariffs or whether all other programs are

⁹⁹ *Id.*, pp. 110-111.

¹⁰⁰ *Id.*, p. 114.

¹⁰¹ *Id.*

¹⁰² *Id.*, pp. 117-118.

¹⁰³ *Id.*, p. 127. Under cross-examination, Mr. Chrysler admitted that he did not have experience in such research tools and that his conclusions were based upon his personal interpretation of the data. *Id.*, pp. 131-132.

¹⁰⁴ *Id.*, p. 136.

optional.¹⁰⁵

Mr. Buckner testified that the Consumer Advocate opposes the proposed FRT because (1) “the proposed fixed rate PGA rider commodity rates are not based on actual cost while the existing PGA guarantees that actual gas commodity costs are recovered,” (2) the fixed rate “includes a risk premium and other risk protection additives which amount to approximately 9 cents per therm or CCF or approximately a 16 percent markup for gas commodity cost” and (3) the program is “not optional for Chattanooga Gas customers.”¹⁰⁶

Mr. Buckner testified that, prior to the institution of the PGA rule, customers’ rates were set by the regulatory agency on the basis of “actual cost at a given point in time.”¹⁰⁷ If the gas utility required an increase in its rates because of increases in the cost of purchasing gas, the utility would have the option of requesting a rate increase from the regulatory agency.¹⁰⁸ Mr. Buckner stated that although customers have not always paid the actual cost of gas, such has not been the case for the past decade.¹⁰⁹ According to Mr. Buckner:

Currently all gas cost are paid for by the customers. There’s no reason for gas customers to pay any more than cost. . .¹¹⁰

Mr. Buckner also stated that gas cost volatility can be mitigated under the existing PGA: “Existing PGA can set a price per therm over a 12 month period . . . It [the PGA] mitigates volatility from a month to month to a 12-month window.”¹¹¹

Under cross-examination Mr. Buckner stated that he was not aware of any surveys or studies relating to customer satisfaction with the current PGA or addressing customer’s

¹⁰⁵ *Id.*, p. 137.

¹⁰⁶ *Id.*, p. 150.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*, p. 171.

¹¹⁰ *Id.*

¹¹¹ *Id.*, p. 156

preferences regarding fixed or variable gas costs. He also admitted that he had not done a study of the volatility of gas prices.

During Mr. Buckner's cross-examination, counsel for Chattanooga Gas requested that the Hearing Officer take judicial notice of comments made during the February 6, 2001 Authority Conference and submitted copies of excerpts of the official transcript from that Conference.¹¹² Without objection, the Hearing Officer took notice of the transcript of the February 6, 2001 Conference. Counsel for Chattanooga Gas then read the following excerpts from that transcript into the record: Page 31, Lines 12-18; Page 32, Lines 11-15; Page 44, Lines 12-18; Page 46, Lines 19-23; Page 50, Line 24 through Page 51, Line 2; and Page 51, Lines 14-18.¹¹³ Mr. Buckner was questioned whether, in light of the comments of the Directors during that February 6, 2001 Conference, it would be reasonable for a tariff to be proposed by Chattanooga Gas that would reduce gas volatility. Mr. Buckner responded that while proposing such a tariff would be reasonable, Chattanooga Gas has had the ability to hedge gas costs, including at the time of the February 6, 2001 Conference.¹¹⁴

FINDINGS AND CONCLUSIONS

Based upon a review of the *Petition* and its accompanying exhibits and after considering the testimony and documentary evidence presented by the parties, the Hearing Officer denies the *Petition* of Chattanooga Gas based on the following findings and conclusions.

- I. **The Authority must determine whether Chattanooga Gas's proposed FRT, which would alter the existing mechanism for establishing gas costs, is just and reasonable, pursuant to Tenn. Code Ann. § 65-5-203.**

The TRA has the authority to act under Tenn. Code Ann. §§ 65-5-201 and 65-5-203 in

¹¹² *Id.*, p. 162.

¹¹³ *Id.*, pp. 165-167.

¹¹⁴ *Id.*, pp. 167-168.

establishing the rates to be set under such a mechanism as proposed by Chattanooga Gas. Pursuant to these statutes, the TRA has the discretion to approve proposed rate changes that have been submitted to it by a utility under its jurisdiction. The Authority considers petitions seeking adjustments of rates and charges under Tenn. Code Ann. § 65-5-203, which provides, in part, that the Authority shall have the power “to hear and determine whether the increase, change or alteration being sought by a public utility is just and reasonable” and that “the burden of proof to show that the increase, change or alteration is just and reasonable shall be on the public utility making the same.” The Authority has wide latitude in setting rates for public utilities under its jurisdiction. The Tennessee Supreme Court held in *CF Industries v. Tennessee Public Service Commission*,

[T]he process of setting rates is not required to follow any particular course, so long as the end result does not violate the just and reasonable standard.¹¹⁵

The TRA has the power to fix just and reasonable rates “which shall be imposed, observed, and followed thereafter” by any public utility.¹¹⁶

II. The Authority’s PGA Rule, which separates the cost of service from the remainder of a gas utility’s rates, is designed, in part, to protect the customer and the utility from the consequences of the over-collection or under-collection of gas costs.

Chattanooga Gas has petitioned the Authority for a change in its PGA rider pursuant to TRA Rule 1220-4-1-.06 and Rule 1220-1-1-.05. In rendering a decision on this request, it is important to reflect on the purpose and history of TRA Rule 1220-4-7 (the “PGA Rule”). The current PGA Rule was adopted by order of the Tennessee Public Service Commission (“TPSC”) in Docket No. G-86-1 and became effective on July 1, 1992. The purpose of the PGA Rule is set

¹¹⁵ *CF Industries v. Tennessee Public Service Commission*, 599 S.W.2d 536, 543 (Tenn. 1980) (quoting *Allied Chemical Corp. v. Georgia Power Co.*, 224 S.E.2d 396, at 399 (Ga. 1976)).

¹¹⁶ Tenn. Code Ann. § 65-5-201. See *Consumer Advocate Division v. Tennessee Regulatory Authority*, 1998 WL 684536, *6 (Tenn. Ct. App.); *Consumer Advocate Division v. Bissell*, 1996 WL 482970 (Tenn. Ct. App.).

forth at Rule 1220-4-7-.02:

These Purchased Gas Adjustment (PGA) Rules are intended to permit the Company to recover, in timely fashion, the total cost of gas purchased for delivery to its customers and to assure that the Company does not over-collect or under-collect Gas Costs from its customers.

The PGA Rule defines "gas costs" in the following manner at Rule 1220-4-7-.01:

"Gas Costs" shall mean the total delivered cost of gas paid or to be paid to Suppliers, including, but not limited to, all commodity/gas charges . . . and any other similar charges which are paid by the Company to its gas suppliers in connection with the purchase, storage or transportation of gas for the Company's system supply.

The PGA Rule includes three major components addressing the collection of gas costs: the Gas Charge Adjustment (GCA), the Refund Adjustment (RA), and the Actual Cost Adjustment (ACA). The ACA is the difference between the revenues billed customers by means of the GCA and the cost of gas invoiced the Company by suppliers plus margin loss (if allowed by order of the TRA in another docket) as reflected in the Deferred Gas Cost account. The ACA provides for a true-up of the difference between the actual gas costs and the gas costs recovered from the customer through a surcharge or a refund. The RA refunds the "true-up" along with other supplier refunds, if any, to the customer. All balances in the Deferred Gas Cost account also bear interest at the recent prime rate.

The PGA Rule serves its intended purpose well. It permits all gas distributors in Tennessee to recover gas costs without extensive proceedings to adjust retail rates. The PGA Rule was not designed to avoid price volatility; it was designed to avoid earnings volatility. Nevertheless, the PGA Rule allows gas distributors to purchase gas with differing terms and conditions that could reduce price volatility as well as earnings volatility as long as such gas is purchased at reasonable prices. It does not allow distributors to make purchases at prices above

a reasonable market price without facing potential penalties.

III. The FRT proposed by Chattanooga Gas, which provides for a mandatory payment by customers of an amount exceeding the actual cost of gas, does not establish a just and reasonable rate.

A. Chattanooga Gas has not demonstrated sufficient grounds to support its request to deviate from the existing PGA Rules or from its own incentive plan.

1. The proposed FRT requires the Customer to pay a risk premium in addition to the actual cost of gas.

In seeking this change in its PGA Rider, in essence the Company is asking the Authority to approve a proposed FRT that amounts to an insurance plan to protect customers against a recurrence of the extraordinary increase in prices like that experienced in 2000-2001. The proposed FRT has the capability of locking in gas costs to a certain extent. However, the proposed FRT deviates from the established method of the setting of rates for gas based on the actual cost of the gas to the Company. Mr. Buckner's testimony points to the fact that, in traditional ratemaking, the cost of service component of rates was set based on a snapshot of the utility's costs of purchasing gas.¹¹⁷ Because subsequent prices varied from the price at the time the snapshot was taken, rates paid by customers did not always reflect the cost to the utility, but there was, importantly, an initial relation between rates and costs.¹¹⁸ The advent of the PGA Rule resulted in a separation of the cost of service component from the remainder of the utility's rates so that this component would more closely reflect the utility's cost of gas as it fluctuated over time. This practice, which the parties admit has been in effect for approximately the last ten (10) years, refines the ratemaking function to ensure, to the extent possible, that rates reflect the

¹¹⁷ *Transcript of Proceedings*, Docket No. 02-00383, May 28, 2002, p. 171.

¹¹⁸ This relation corresponds to the statutory requirement that rates not be "excessive." Tenn. Code Ann. § 65-5-201. It is a normal component of ratemaking, whereby rates are designed to compensate for operating expenses. See 64 AM. JUR. 2D *Public Utilities* §§ 133,173 (1972).

utility's gas costs.¹¹⁹ The converse of this principle should also be respected in setting rates: the utility's rates should not extend beyond the utility's cost of providing the service.¹²⁰ Specifically, for purposes of this proceeding, the Company's rates for gas should not extend beyond the Company's cost of purchasing the gas. Yet this is what the FRT proposes to do. The risk premium, which is the vital component of the proposed FRT, is not part of the Company's cost of purchasing the gas it sells to its customers. Including the risk premium in the Company's rates contradicts the established policy and practice that rates generally should reflect costs. Although the Authority might, in compelling circumstances, deviate from this principle, the record in this proceeding does not demonstrate that such compelling circumstances exist.

In adopting the PGA Rule, the Authority's predecessor agency, the TPSC, determined that exposure to a certain amount of price volatility was necessary in order that gas customers' prices could more directly reflect the utility's gas costs. The continued existence and application of the PGA Rule supports a presumption that this policy determination by the TPSC remains valid and this policy should not be disturbed absent compelling reasons. The Hearing Officer finds that the Company's proposed FRT clearly runs counter to the TPSC's determination and the regulatory policy embodied in the PGA Rule, and that the Company has not met its burden of demonstrating that the Rule and its attendant policy should be dispensed with in this instance.

From the perspective of Chattanooga Gas, the insurance premium may be considered as a component of the "total cost of gas purchased for delivery," but it is not a part of the actual cost

¹¹⁹ This principle is reflected in the PGA Rule, specifically at Authority Rule 1220-4-7-.02(1), which provides: These Purchased Gas Adjustment (PGA) Rules are intended to permit the company to recover, in timely fashion, the total cost of gas purchased for delivery to its customers and to assure that the Company does not over-collect or under-collect Gas Costs from its customers.

This principle is further incorporated in Authority Rule 1220-4-7-.04, also a part of the PGA Rules, which is intended to "appropriately match revenues with cost of purchased gas."

¹²⁰ This statement is only intended to encompass the gas cost portion of the rates. Utilities are, of course, compensated for other expenses through their rates.

of gas. It is an add-on, designed to hedge against the potential of high gas costs in the future. If approved and implemented, the proposed FRT would shield the customer from a high ceiling of gas costs in the event of an extreme increase in gas costs. In such an instance, the customer may receive a benefit which could be quantified by determining the difference between the amount paid for by the customer for the "premium" over a period of time and the actual cost of gas during the time of the spike in gas costs. In such an instance, both the Company and the customer benefit. On the other hand, there would be no benefit to the customer if the cost of gas did not increase or, in fact, decreased. In such an instance the Company most likely would benefit and none of the premium paid would be returned to the customer. While such a scenario may appear fair in terms of shifting the risk of higher gas cost, it is not just and reasonable when imposed upon the customer without option.

2. **The risk premium in the proposed FRT has been calculated in an arbitrary manner based on the Company's current rate of return.**

Nor has the Company provided a convincing explanation for its determination of the risk premium. According to the testimony, the Company arrived at a risk premium based on current conditions that fortuitously approximated the Company's authorized rate of return. Even though the amount of the rate of return became the operative figure for determining the risk premium, the Company demonstrated no functional correlation between the amount of the rate of return and the calculation of the risk premium. Nevertheless, the rate of return serves as the basis for the risk premium and will continue to do so in the succeeding years of the proposed program. Even though the Company has gone to great lengths to precisely quantify the proposed fixed rate through an extensive, all-encompassing formula, the risk premium, a crucial aspect of the fixed rate, appears to have been arrived at in an almost arbitrary manner. For the Authority to adopt such a formula might also be deemed arbitrary.

3. **The proposed FRT improperly shifts the responsibility for making gas purchasing decisions from the Company to the TRA.**

The proposed FRT raises problems in terms of the role specified for the Authority. Each September, according to the proposed tariff, the Company would present the Authority with its proposed fixed rate for the next twelve (12) month period. The Authority would then have twenty-five (25) days within which to determine whether to accept this rate or suspend the plan for an entire year until the following October. This procedure inevitably, and perhaps improperly, places the Authority, not the Company, in the role of assessing risk for both the Company and its customers.¹²¹

The cost of gas on the monthly spot market, which is where the Company currently purchases a large portion of its gas, could vary greatly from the fixed rate set each October. Several scenarios are possible. The Authority might approve a rate for the FRT that turns out to be much higher than the price available during the succeeding winter on the monthly spot market. This would result in customers paying more for gas under the FRT than actual gas costs to the Company. On the other hand, the Authority might reject an FRT rate that turns out to be much lower than prices later charged during the winter on the monthly spot market. Under either scenario, the Authority would be required to act as a surrogate for the Company in making purchasing decisions and in assessing risks that are associated with and properly a part of

¹²¹ Chattanooga Gas has submitted information to support and explain how the risk premium will be calculated to arrive at a fixed rate under the FRT. It is worth noting, however, that Chattanooga Gas cannot confidently state how great the risk may be, or even identify all types of risk that may be involved. Chattanooga Gas states, in response to a data request from the Consumer Advocate:

To the Company's knowledge, the Fixed Rate PGA tariff is a novel proposal that has never before been attempted by any other gas utility in Tennessee. By its very nature, this particular filing requires the Company to take a certain amount of risk in making it available. The Company has taken a great degree of care in trying to properly identify these risks. However, since this filing has never before been implemented, the complete and total risks are unknown.

Response to Consumer Advocate and Protection Division May 2, 2002 Data Request, Docket No. 02-00383, May 7, 2002, Item 7.

business decisions in the gas industry. It is not the role of the Authority to exercise its judgment in purchasing gas, assessing risk, or predicting the weather. The procedure contemplated by the proposed FRT, which requires the Authority to analyze the market, forecast the weather, and reach a decision within twenty-five (25) days, would most certainly subject the Authority to second-guessing.¹²²

B. If approved, the risk premium in the proposed FRT will be mandatory, not optional, for the Company's customers.

One of the major objections of the Consumer Advocate to this FRT is that the program is not optional to Chattanooga Gas customers. Mr. Buie testified regarding Chattanooga Gas's decision not to offer the proposed FRT as an option to its customers:

Our examination revealed that the cost of changing our computer billing system to manage those customers who chose a fixed rate and others that chose to remain on a variable rate would be prohibitive. In addition, we also found that it would require and extensive customer education campaign as well as additional training and staffing in our call center. Despite all of these costly changes, there was no way to know for certain exactly how many customers would elect this service. Because of these reasons, we abandoned this approach in favor of the Fixed Rate PGA Tariff that we are presenting to the Authority today.¹²³

During the Hearing, Mr. Buie reiterated that offering the FRT as an optional program would be cost prohibitive.

As demonstrated in the record, the risk premium is derived from the Company's rate of return. When this rate of 9.08% is applied to the costs identified in the FRT, a risk premium of approximately \$0.05 per Ccf is produced. The Consumer Advocate testified that "the risk

¹²² Mr. Novak's testimony suggests that the Authority's determination whether to accept or reject the proposed fixed rate each October would resemble the current prudence audit. In other words, the Authority's acceptance of the proposed rate would carry no greater significance than a finding that the Company made prudent purchases of futures contracts through a comparison with the contemporary futures market. It seems inevitable, however, that the Authority's decision would be questioned, either by the Company or the customers themselves, in the event a significant price variation causes the Authority's decision to seem imprudent. See *Petition*, Exhibit B, p. 11, and *Transcript of Proceedings*, Docket No. 02-00383, May 28, 2002, p. 115.

¹²³ *Id.*, p. 5.

premium and risk protection additives” amounted to a 16% mark up over estimated costs.¹²⁴

The Hearing Officer finds that the “fact” that the Company may incur substantial (or “prohibitive”) costs in making changes to its billing system and in educating its customer base is not a sufficient reason to make the FRT mandatory for customers. The PGA Rule establishes a just and reasonable mechanism for the recovery of gas costs. Providing the customer with an optional means of hedging gas costs might also be just and reasonable. Nevertheless, the record in this case does not support the establishment of a FRT that requires the customer to pay an amount greater than actual gas costs.

Further, the evidence in the record does not support the Company’s position that Chattanooga Gas customers favored a FRT. In its *Petition*, Chattanooga Gas stated that it was filing in “support of this proposed tariff” the testimony of Beverly Wright reflecting the attitudes of randomly selected Chattanooga Gas customers (focus groups) toward an annual fixed rate tariff.¹²⁵ Further, in the pre-filed testimony submitted with the *Petition*, Larry Buie stated that

The conclusions of these focus groups confirmed my suspicions that our customers did in fact place a value on price certainty, and that a Fixed Rate PGA mechanism was an appropriate tool to achieve this stability.¹²⁶

The Hearing Officer does not find the evidence related to focus groups to be helpful in ascertaining whether the FRT is an appropriate mechanism for establishing gas costs to consumers. It is difficult to see the value of this information when the results of the focus groups are, as their moderator admitted, not capable of being extended to the Company’s larger customer base.¹²⁷ Further, if they could be interpreted as representative of the attitudes of

¹²⁴ Direct Testimony of Robert T. Buckner, Docket No. 02-00383, May 21, 2002, p. 7.

¹²⁵ *Petition*, at p. 123.

¹²⁶ *Petition*, Exhibit B, Testimony of Larry Buie, p. 3.

¹²⁷ *Transcript of Proceedings*, Docket No. 02-00383, May 28, 2002, p. 44.

Chattanooga Gas's customers, the results of the focus groups only show about a third of the customers favoring the FRT proposal, with about an equal number opposing it.¹²⁸ Such results do not support a radical change in the manner in which customers will be charged for gas, particularly when the program is not optional. In the absence of a compelling customer mandate in favor of the FRT, the Hearing Officer declines to add an additional amount to customers' rates that is not related to the Company's cost of purchasing gas, or to put the Authority in the improper role of risk assessment. Further, the Hearing Officer does not find that customer attitudes, such as those solicited in the manner here, are relevant in assisting the Authority in its role to determine whether the Company's rates are just and reasonable.

In addition to the evidence concerning the focus groups, the record contains several indications that gas customers in general are not particularly concerned with price volatility. Only eleven percent (11%) of the Company's residential and two percent (2%) of its commercial customers have elected budget billing programs, a method already available to alleviate fluctuations in gas bills.¹²⁹ A fixed rate plan available in Georgia on an optional basis has only a five percent (5%) enrollment.¹³⁰ These facts weigh against adoption of a mandatory plan.

IV. The TRA did not establish a mandate for an FRT such as proposed by Chattanooga Gas.

Chattanooga Gas asserts that its FRT proposal has its origins, in part, in statements made by the Authority's Directors during the February 6, 2001 Authority Conference. During that Conference, the Directors received and responded to comments from representatives of the three

¹²⁸ *Id.*, p. 37.

¹²⁹ Response to Consumer Advocate and Protection Division May 13, 2002 Data Request, Docket No. 02-00383, May 17, 2002, Item 2.

¹³⁰ Response to Tennessee Regulatory Authority Staff Data Request No. 1, Docket No. 02-00383, April 23, 2002, Item 4.

(3) major local gas distribution companies in Tennessee (Chattanooga Gas, Nashville Gas Company and United Cities Gas Company) regarding unusually high gas bills experienced in the winter of 2000-2001. Notwithstanding the fact that the Directors made extensive remarks about high gas bills and how the companies could work with customers toward payment of those bills, Chattanooga Gas has interpreted the Directors' statements as amounting to a mandate to make every attempt to remove volatility from gas prices. This interpretation is not borne out by the transcript from that Conference. The Hearing Officer finds, upon review of the transcript of the February 6, 2001 Authority Conference, no clear evidence that the Directors ever mandated such action by the gas distribution companies.

By its own testimony, Chattanooga Gas acknowledges, "What we experienced in January 2001 was very cold weather at the same time that gas prices reached a peak."¹³¹ Mr. Novak testified that there are two (2) major causes of price volatility, the lack of supply and unusually high demand due to colder than normal weather. During the winter of 2000-2001, a combination of unusually high gas prices and unusually cold weather caused an extraordinary spike in customers' bills.¹³²

The Company's FRT proposal relates only tangentially to the concerns expressed by the Directors at the February 6, 2002 Authority Conference. To a certain extent, the Directors comments touched on the subject of volatility, but the Directors' comments reveal that they were chiefly concerned with the fact of high bills during a particular isolated period, and not with the general volatility that is characteristic of the gas market. The Directors focused on the impact of high bills on the customers and requested that the gas companies be "compassionate" in

¹³¹ *Transcript of Proceedings*, Docket No. 02-00383, May 28, 2002, p. 6.

¹³² *Id.*, pp. 97-98.

collecting unpaid bills.¹³³ The Directors specifically mentioned deferred payment options.¹³⁴ The Directors did not discuss the use of futures contracts as a method of leveling prices. One cause of the high bills in 2000-2001 was high wholesale gas prices. The Company admits that the proposed FRT is not designed to obtain the lowest possible wholesale (and thus retail) price for gas, but merely to level retail prices, which is not the same thing. Another factor that caused high prices in 2000-2001 was unusually cold weather, and the proposed FRT does nothing specifically to compensate for volatility in the weather. Under the proposed program, customers' bills will continue to fluctuate with changes in temperature. The Hearing Officer does not conclude, therefore, that the Company has a clear mandate from the Authority to take extraordinary steps to address price volatility in isolation, or that the necessity for such steps is so clear as to require a mandate at this time.

The Consumer Advocate also raised an objection to the FRT on the basis that the FRT would provide an improper windfall to Chattanooga Gas's purchasing arm, Sequent. It appears that if certain conditions prevail, a profit will be made as a result of the proposed FRT. It is troubling that even though the Company acknowledged that a profit could result from the FRT, it does not know whether such a profit would go to Chattanooga Gas, Sequent, or some other entity.¹³⁵ It is also a matter of concern that the Company declines to take bids during the early stages of the program when competitive bidding itself could serve as an important factor in lowering the price at which the Company purchases gas.¹³⁶ Nevertheless, because the Hearing Officer rejects the proposed FRT on other grounds, the Hearing Officer finds it unnecessary to resolve the affiliate transaction issues that arise from the proposed FRT.

¹³³ See *Transcript of Directors' Conference*, February 6, 2002, p. 46.

¹³⁴ See *id.*, pp. 48, 50.

¹³⁵ *Transcript of Proceedings*, Docket No. 02-00383, May 28, 2002, pp. 20,88.

¹³⁶ *Id.*, pp. 19,80.

IT IS THEREFORE ORDERED THAT:

1. Chattanooga Gas Company's Petition for Approval of Change in Purchased Gas Adjustment is denied.
2. Any party aggrieved by the Hearing Officer's decision in this matter may file a Petition for Reconsideration with the Hearing Officer within fifteen (15) days from the date of this Order.
3. Any party aggrieved by the decision of the Hearing Officer in this matter may file a Petition for Appeal with the Tennessee Regulatory Authority within fifteen (15) days from the date of this Order.
4. In the event this Order is not appealed to the Directors of the Tennessee Regulatory Authority within fifteen (15) days, this Order shall become final and shall be effective from the date of entry. Thereafter, any party aggrieved by the decision of the Hearing Officer may file a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from the date of this Order.

J. Richard Collier
Richard Collier
Hearing Officer

entered: August 30, 2002